

***United States Court of Appeals
for the Second Circuit***



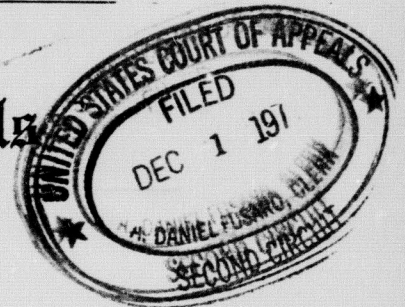
**APPELLANT'S
BRIEF**

77-5019

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P/S

Consolidated Appeals:
77-5019, 77-5022

United States Court of Appeals
For the Second Circuit



In the Matter of

STIRLING HOMEX CORPORATION, *Debtor*

GREGORY JEZARIAN, GERALDINE JEZARIAN, LONETOWN COMPANY, HARRY E. JONES, ALECK GOLDBERG, as Custodian for Mark Goldberg, and MRS. D. WINDSOR DIXON,

Appellants,

FRANK G. RAICHLE, Reorganization Trustee; LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL BANK; THE CHASE MANHATTAN BANK, N.A.; THE FIRST NATIONAL BANK OF CHICAGO; MARINE MIDLAND BANK; and THE TRAVELERS INDEMNITY COMPANY,

Appellees.

**Appeal from the United States District Court
for the Western District of New York**

APPELLANTS' BRIEF

POMERANTZ LEVY HAUDEK & BLOCK
Attorneys for Appellants
Gregory Jezarian, Geraldine Jezarian
and Lonetown Company
295 Madison Avenue
New York, New York 10017
(212) 532-4800

MILBERG WEISS BERSHAD &
SPECHTRIE
Attorneys for Appellants
Harry E. Jones and Aleck Goldberg,
as Custodian for Mark Goldberg
One Pennsylvania Plaza
New York, New York 10001
(212) 594-5300

BADER & BADER
Attorneys for Appellant
Mrs. D. Windsor Dixon
270 Madison Avenue
New York, New York 10016
(212) 532-6860

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Docket Nos. 77-5019
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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

In the Matter of

STIRLING HOMEX CORPORATION, Debtor

GREGORY JEZARIAN, GERALDINE JEZARIAN,
LONETOWN COMPANY, HARRY E. JONES,
ALECK GOLDBERG, as Custodian for Mark
Goldberg, and Mrs. D. WINDSOR DIXON,

Appellants,

FRANK G. RAICHLE, Reorganization Trustee;
LINCOLN FIRST BANK OF ROCHESTER; CHEMICAL
BANK; THE CHASE MANHATTAN BANK, N.A.; THE
FIRST NATIONAL BANK OF CHICAGO; MARINE
MIDLAND BANK; and THE TRAVELERS INDEMNITY
COMPANY,

Appellees.

Appeal from the United States District
Court for the Western District of New York

APPELLANTS' BRIEF

These consolidated appeals in a Chapter X reorganization
are from an order dated July 27, 1977 of the District Court

for the Western District of New York, Hon. Harold P. Burke, D.J. The order subordinates the claims of allegedly defrauded past and present stockholders of the debtor to the claims of its conventional general creditors. Since the debtor is insolvent, subordination of stockholders' fraud claims is tantamount to rejection.

Appellants are shareholders of the debtor. They allegedly were induced to buy their shares by fraudulent acts and omissions of the debtor constituting violations of the Securities Acts.

The opinion below is unreported.

ISSUES PRESENTED

1. In a Chapter X reorganization, have obviously meritorious and readily provable claims of allegedly defrauded purchasers of the insolvent debtor's securities been properly subordinated to claims of conventional general creditors, thereby barring stockholder-claimants from participation in the debtor's estate?

2. Have such fraud claims of past and present holders of the debtor's common stock been properly subordinated to claims of the debtor's bank creditors, in the face of the banks' extension of \$37 million of credit to the debtor as against only \$8.5 million of capital contributed by such stockholders?

3. Have such fraud claims of past and present holders of the debtor's preferred stock been properly subordinated to claims of the debtor's bank creditors in the face of uncontradicted evidence that the bank creditors did not rely on the preferred stockholders' investment in the debtor?

4. Should the bank creditors' claims be equitably subordinated to such fraud claims of past and present stockholders of the debtor who bought their shares after issuance of a false prospectus for the debtor's stock, if it be established, as charged in a pending lawsuit, that the banks aided and abetted and conspired in the issuance of a false prospectus?

If the Court should decide that claims of allegedly defrauded purchasers of the debtor's common or preferred shares, or of both issues, should rank with claims of conventional general creditors or with (or ahead of) the claims of only the bank creditors, these further issues should be determined:

5. Was an order which required the filing of all claims, "other than those founded on ... shares of stock", effective to bar claims founded on purchases of stock induced by fraud?

6. Was the same order, because it was published, effective to bar claimants whose names and addresses were known but disregarded when the order was mailed to creditors?

7. In a Chapter X reorganization, may stockholders' fraud claims fairly be called for before the Trustee files his § 167 report?

STATEMENT OF THE CASE

1. Nature and status of the reorganization proceedings and condition of the debtor.

This proceeding was initiated by a petition filed on July 12, 1972 by the debtor, Stirling Homex Corporation, under Chapter X of the Bankruptcy Act. A1. Claims accepted by the Trustee approximate \$46.6 million. A166. By order dated June 13, 1977 the District Court found the fair value of the debtor's estate to be approximately \$17 million, the debtor to be insolvent, and the stockholders without equity in the debtor. A267.

The Trustee having reported, A173-4, that reorganization is unfeasible, the same order of June 13, 1977 directed, A267, ¶4, that the debtor "continue in reorganization under Chapter X to enable the Trustee to prepare and submit a plan in the nature of an orderly liquidation of the remaining assets of the consolidated debtor, which plan shall be prepared and presented in accordance with the orders of this Court." Promulgation of a reorganization plan now awaits the outcome of these appeals.

2. The debtor's sales of its securities and resulting losses sustained by public investors.

Stirling Homex Corporation made two public offerings of its securities:

1. 1,175,000 shares of common stock were offered on February 19, 1970 at \$16.50 per share.¹ Within a few days the shares traded at prices exceeding \$50 per share, more than 200 times earnings, in the over-the-counter market. A157.

2. 500,000 shares of convertible preferred stock were offered on July 29, 1971 at \$40 per share. Id. These shares also traded in the over-the-counter market. A430, ¶26.

Of the \$39 million in total proceeds of the two offerings, the debtor realized \$25,100,000. A157. The loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as \$100,000,000. A157, A219.

3. The debtor's business and its fraudulent accounting.

Stirling Homex was organized and commenced operations in 1968. A157. Its business was the manufacture and sale of modular housing units for two-story wood frame town houses and apartments. Id. The units were manufactured at the Company's plant in Avon, in upstate New York. Id. They were designed

1. 400,000 of these shares were sold for the debtor's account. A157. The remainder were sold for members of management and other insiders.

for shipment to the construction site by truck or rail, elevation by crane to the foundation, and joinder to one another and the foundation. Id.

Throughout the pre-bankruptcy period Stirling Homex kept its books in a deliberately false and misleading fashion, in order to create or inflate income. A158, last ¶; A276, 2d¶. The method principally used was the recognition of sales and income on completion of manufacture of modules, in most instances merely on the strength of hopes or expectations that the modules would later be installed and paid for by local housing authorities and other non-profit entities which were the Company's principal customers. A283-6, A296. In one instance, accounting for 62.8% of module sales and over 44% of total revenue for a seven-month period reflected in the prospectus for the second public offering, recognition was predicated upon a contract with a shell corporation and a forged financing commitment of a federal agency. A283, fn.67; A288. The remainder of the module sales during the same period likewise were improperly recorded, for lack of a firm contract or a firm financing commitment. A288-91. Most of these "sales" never materialized; these transactions, and others equally infirm, were later booked as "sales" and "income" for the Company's fiscal year ended July 31, 1971. A291-4. On its sparse legitimate transactions the debtor also created or inflated income by showing profit on the manufacture of modules while ultimately incurring losses on the installation and site work. A283, A285.

By reason of the foregoing, thousands of buyers of the debtor's preferred and common stock became victims of one of the more notorious among latter day securities frauds.

4. The ready provability of claims of defrauded stockholders, contrary to the District Court's finding.

The opinion-order below states that it was made "in the exercise of discretion." A446. The only findings or observations contained in the opinion which refer to the particular claims at bar and, accordingly, the only discernible factual basis for Judge Burke's subordination of stockholder-claimants as a discretionary matter, is the following paragraph of the opinion:

"The stockholders claims based on fraud or other violations of securities laws, are contingent and unliquidated. The contingent claimants are not now and may never be creditors of the consolidated debtor. A determination of the claims involves serious factual and legal issues. Substantial disputes may well be expected to arise in establishing the claims of any such alleged creditors, the application of limitation of actions and the measure of damages." A444.

The foregoing wholly ignores heavy documentation in the record which establishes precisely the opposite of what seemingly moved the District Judge to rule against defrauded stockholders "in the exercise of discretion." In short, the record shows that the claims of defrauded security holders,

while unliquidated, are plainly meritorious and easily proven as regards both liability and damages.

To begin with, the debtor's false and misleading accounting practices were acknowledged in the Reorganization Trustee's report under § 167 of the Bankruptcy Act, one of the papers attached to the notice of hearing resulting in the order under review:

"Finally, to fully understand the causes of the failure of Debtor, it is necessary to comment on its accounting practices. Almost from the beginning, its financial statements were distorted by the premature recognition of sales. Because Debtor recognized sales essentially at the point when a prospective customer for its modules was identified and completed modules could be assigned to a 'project', Debtor was encouraged to continue the production of modules in fact for inventory, while treating them as part of 'sales'. Another accounting practice which distorted reality was the so-called 'front loading' of profit on the modules and ultimately taking losses on the site work. Since each project required Debtor to accomplish both the manufacture of the modules and the site work, this practice misled the management of Debtor and others as to how well Debtor's business was doing and discouraged corrective action until it was too late." A158.

The Securities and Exchange Commission conducted an in-depth investigation into the causes of the debtor's failure. A275. The Commission followed its investigation with an injunction action against the debtor and others for violations of the anti-fraud provisions of the Federal Securities Laws. Id. The Commission's complaint in that action was thus summarized in its July 2, 1975 litigation release:

"In particular, the Complaint alleges that from 1970 through 1972 the financial statements of Stirling Homex were materially falsified by the fraudulent recording and reporting of fabricated or fictitious sales and the application of inappropriate accounting principles. For example, all module sales of approximately \$12,500,000 included in the February 28, 1971 financial statements contained in the 1971 Registration Statement of Stirling Homex, were either fictitious or improperly recorded including approximately \$8,000,000 of sales from a proposed \$15 million project in Mississippi with the Greater Gulf Coast Housing Corporation. As part of this fraudulent course of conduct designed to deceive the public materially false and misleading registration statements in 1970 and 1971 were filed with the Commission and disseminated to the public by Stirling Homex. Materially false and misleading press releases and letters to the shareholders were issued and materially false and misleading annual and periodic reports were filed with the Commission." A276.

The foregoing is persuasively supported and detailed by the Commission's concurrent Accounting Series Release # 173. A281 et seq.

On January 29, 1977 the principal officers of Stirling Homex were convicted, following a jury trial before Judge Frankel in the Southern District Federal Court, of a variety of crimes including the defrauding of Homex's public stockholders. A270. The convictions covered all counts of the indictment including those charging fraud in the preparation and dissemination of the registration statements covering Stirling Homex's two public issues. Id.; A298. (The convictions have been appealed to this Court which, after hearing oral argument, has the appeals under advisement.²)

Judge Burke was seriously in error, we accordingly submit, in holding, A444, that "A determination of the claims [of defrauded security holders] involves serious factual and legal issues." The District Judge was also in error, we contend, in his conclusion, Id., that fixing of claims of individual stockholders will give rise to substantial disputes involving "the application of limitation of actions and the measure of damages".

In mentioning limitations as a problem, the District Judge seems to have overlooked that § 11(f) of the Bankruptcy

2. U.S.A. v. David Stirling, Jr., et al., Docket No. 77-1140.

Act, 11 USC § 29(f), suspends operation of any statute of limitations commencing with the filing of the petition - which was only thirty months after the first public offering.

Individualized damages likewise should not present a problem because it is easily demonstrated that the debtor's stock was worthless at all relevant times.³

5. The role herein of the Jezarian claimants; events and proceedings leading to the order appealed from.

Of the \$46.6 million of accepted claims against the debtor, \$38 million consist of claims filed by a consortium of nine banks. A166-8. The banks initially claimed as secured creditors, asserting liens against virtually all the debtor's assets. A168.

Had the banks' liens been sustained, they would have consumed the bulk of the estate and left little for general creditors. This was the seeming condition of the debtor's estate until March 31, 1976. On that date the banks unexpectedly

3. The Securities and Exchange Commission found that as of February 28, 1971 the Company's improperly recorded accounts receivable exceeded \$24.5 million. A291, §(f); A288, 1st¶. This compared to reported stockholders' equity as of that date of only \$12.7 million. A374. Impairment of the stockholders' equity was a cumulative process until bankruptcy. A282; A276; A294, fn. 87; A321-3. While the record herein does not reflect impairment of the stockholders' equity for the period before February 28, 1971 with equal clarity, it is nonetheless apparent that the Company's condition in the earlier period, if not insolvent, was highly marginal. A314-19.

entered into a settlement agreement with the Trustee whereunder they released their purported liens and accepted general creditor status for their entire \$38 million of claims, in consideration of an advance payment of \$7 million on account of their general claims. A55, A86-7. The District Court approved this settlement by order of June 29, 1976, A142, following perfunctory hearings before Bankruptcy Judge Hayes and District Judge Burke, A61, A125. Judge Hayes found, at that time, that the estate should net some \$17 million for distribution to general creditors. A112, ¶14.

Claimants-appellants Gregory and Geraldine Jezarian and Lonetown Company at that time were (and still are) the plaintiffs in a certified class action pending in the District Court for the Southern District of New York, in behalf of defrauded security holders of Stirling Homex Corporation; Jezarian v. Csapo, 72 Civ. 1671 (DBB). A334, A190. When the banks' release of their purported liens became known, the Jezarians and Lonetown Company, through their attorneys, opened discussions with the Trustee with a view to according defrauded holders participation in the forthcoming reorganization, a result which had been achieved by consent in other recent bankruptcies of public companies.⁴ A412.

4. Westec Corp., S.D. Tex., 66-H-62; Four Seasons Nursing Centers of America, Inc., 472 F. 2d 747, 749-50 (10 Cir. 1973); Farrington Manufacturing Company, E.D. Va. No. 17-71-A; American Loan and Finance Company, E.D. Va. No. 508-72-N; Dolly Madison Industries, Inc., E.D. Pa. No. 70-354; Equity Funding Corporation of America, 416 F. Supp. 132, 150-2 (C.D. Cal.1975); King Resources Company, et al., D. Col. 71-B-2921, 72-B-644.

The Trustee was receptive to the general concept. See A250. He applied for and obtained an order, inter alia, fixing a hearing to determine "whether the stockholders who have heretofore filed proofs of claims based on fraud or other securities law violation shall be included as general creditors for the purpose of participation in any distribution under any adopted Plan of Reorganization." A150. At that hearing, held on June 13, 1977, the issue was broadened by consent "to include a determination of the claims of the allegedly defrauded stockholders, past and present, whether they had theretofore filed proofs of claim or not." A442, A212.

The Jezarian class plaintiffs were hopeful, until that time, that a compromise could be reached. It developed at and following the hearing, however, that the major creditors (the banks and Travelers Indemnity Company) were unalterably opposed to any meaningful participation for defrauded security holders. A238-46. Accordingly, it was incumbent on the parties to address the classification question on the merits; and they did so in their post-hearing papers. A269, A401.

6. Appellees' contention that claims of defrauded stockholders are time-barred except for six such claims totalling \$21,869.

In the court below several of the debtor's conventional general creditors contended that an order of the Bankruptcy Court directing the filing of claims by February 19, 1973, A24, ¶1, effectively bars any current presentation of claims

by defrauded security holders.⁵ A240-2, A245; A401, ¶2.

Although the opinion below does not allude to this contention, we expect it to be urged here again.

According to the Trustee's § 167 report, only six allegedly defrauded shareholders filed claims before February 19, 1973, for a total of \$21,869. A173. Two of such claims, for a total of \$6,563, were filed by claimants-appellants Jones and Goldberg. Id., A27. None was filed by the remaining claimants-appellants.

Stirling Homex has thousands of defrauded shareholders possessed of well-publicized claims for tens of millions of dollars. Why, then, are there only six "timely" claims for an insignificant total of \$22,000? The reason is that the critical passage of the bar order excepted stockholders' fraud claims:

"1. All proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated, other than those founded on ... shares of stock, shall be filed with the Trustee of the debtors, at 10 Lafayette Square, Buffalo, New York 14203, on or before February 19, 1973; ...". A24, 1st ¶; under-

5. The Reorganization Trustee, on the other hand, stated that he is not relying on the bar order. A250.

scoring added.

When the bar order was drawn and entered in December 1972, A3, a class action brought by claimants-appellants Jezarian et al. in behalf of the debtor's defrauded security holders had been pending against the debtor and others for seven months.⁶ A335, A271. Further, the Reorganization Trustee had interrogated a number of officers and employees of the debtor and was well aware that the class action was a serious lawsuit.⁷ Surely, if the intention was to encompass claims of allegedly defrauded security holders, plain language easily could have been used to alert the public investors to the limited time for filing their claims if they were not to be forever barred. See Point IV(A), infra.

That the early bar order was not intended to cover claims of defrauded stockholders is further indicated by the

6. The debtor has since been dropped as a defendant in deference to a stay of proceedings against the debtor, ordered at the inception of the reorganization. Record, doc. #2 (order approving petition), ¶20; A417.

7. The transcripts of those examinations were incorporated by reference in the affidavit submitted below by counsel for claimants-appellants. A269-70. Counsel refrained from physical attachment of all the bulky transcripts, on advice by the Trustee that they either had been filed with the Clerk of the District Court or would shortly be filed. A270. When the record was transmitted to this Court, however, it appeared that such transcripts had not been filed in the District Court; hence they were not before the District Judge and had to be omitted from the present record. See Dictograph Products Company v. Sonotone Corp., 231 F. 2d 867 (2d Cir. 1956).

mode of its service: In compliance with ¶ 10 of the same order, A25, mailing was "to all ... stockholders at the addresses shown on the records of the debtors or as otherwise known to the Trustee ..." - i.e., to stockholders of record at the close of business on December 29, 1972. A42. Many defrauded shareholders had disposed of their shares before that date. In the normal course, disposition of their shares would be followed by transfers into the names of the vendees, so that the former holders would not appear among the then stockholders of record. If the aim had been to bar defrauded stockholders, then the bar order should have been mailed not only to then current shareholders of record but to all shareholders of record throughout the period since the initial public offering of the Company's shares.

At the hearing resulting in the order appealed from, the Trustee conceded that the names and addresses of former shareholders were available from the Company's transfer records. A248-50.. He offered, by way of excuse for not utilizing them, that the labor and expense would have been prohibitive. Id. Claimants-appellants contended below, A221-2, A262-3, and they urge herein, Point IV(B), infra, that due process mandates notice by mail to all creditors whose names and addresses are known.

7. Posture of the several claimants-appellants and the issues presented by their respective appeals.

All the claimants-appellants bought common or preferred stock of the debtor prior to the bankruptcy and incurred

losses by reason thereof.⁸ All the claimants-appellants were shareholders of record when notice was given of the bar order, discussed in the preceding section hereof.

As previously noted, Jones and Goldberg, alone among appellants, filed fraud claims before the bar date. In his § 167 report, the Trustee advises that the fraud claims of Jones and Goldberg "remain open". A173. The subordination order below, however, effectively excludes these claimants from participation in the insolvent debtor's estate. Realistically, the claims of Jones and Goldberg have been rejected.⁹

8. The transactions of Gregory Jezarian, Geraldine Jezarian and Lonetown Company are set forth at A189-90; A423, ¶¶9,10; of claimants-appellants Jones and Goldberg, at A423, ¶¶11,12; and of claimant-appellant Dixon, at A185.

9. With settlement out of the picture following the June 13, 1977 hearing which preceded the order under review, see p. 13, *supra*, Jones and Goldberg joined the Jezarian group of claimants in submission of post-hearing papers. Claimants' post-hearing affidavit recited that it was submitted in behalf of Jones and Goldberg as well as of the Jezarians and Lonetown Company. A269. The attorneys for Jones and Goldberg, for the filing of their fraud claims and for later proceedings thereon in the court below, see fn. 11 *infra*, as well as for this appeal, have been and are the firm of Milberg Weiss Bershad & Specthrie, formerly Milberg & Weiss. A30, A44, A450.

The remaining claimants-appellants are likewise aggrieved by the subordination order. They are further aggrieved by the misleading text of the bar order, if it is to be applied in bar of their fraud claims; see pp. 14-15, supra; Point IV(A), infra.

We submit that if the fraud claims of Jones and Goldberg are found to have been improperly subordinated to claims of conventional general creditors, this Court should also determine both questions relating to the applicability of the December 11, 1972 bar order - i.e., (1) the sufficiency of the text, and (2) the sufficiency of the notice thereof to former stockholders whose names and addresses were known but ignored in the mailing of the bar order; see Point IV, infra. Otherwise there almost surely will be further resort to this Court to ascertain whether all but \$22,000 in claims of six defrauded stockholders have long since been barred, as some of our adversaries contend; or, as maintained by these appellants, proof of such claims has yet to be called for in a fashion complying with due process of law.

Some of our adversaries argued below, and no doubt they will contend in this Court, that claimants-appellants have no standing to question the failure to mail the bar order to former stockholders because no appellant is a former stockholder who was deprived of notice by mail. Our answer to this is that

the ultimate issue is the framing of a fair plan of reorganization.¹⁰ The Supreme Court has held that the courts should entertain any and all meritorious points and objections going to the fairness of the terms of reorganization, even if they go beyond the objectors' individual interests. Comstock v. Group of Institutional Investors, 335 U.S. 211, 226-7 (1948).

In our view, former shareholders are threatened with complete extinction of any possibility of participation in the debtor's estate, notwithstanding that they were never adequately advised that (as now alleged) they were included in the early call for claims. The Jezarians and Lonetown Company are certified representatives of purchasers of the debtor's securities, between March 16, 1971 and the bankruptcy, in a pending class action. A190. While appellants recognize that class claims do not lie in this proceeding¹¹ and while appellants do not pretend to any technical status herein as class representatives,

10. Or, perhaps, more realistically, a plan of liquidation. A173-4.

11. Claimants-appellants Jones and Goldberg filed fraud claims against the debtor not only in their own behalf but in behalf of a class consisting of others similarly situated. By decision and order filed July 25, 1975, the District Court disallowed the class portion of the Jones and Goldberg claim. A44. That ruling is not contested on these appeals. Thus, if the Court should agree with the views expressed here, we would think it appropriate that it mandate the District Court to order the Trustee to solicit claims from defrauded security holders on an individual basis. It would follow also that defrauded security holders who perfect their claims would be on the same footing as conventional general creditors for purposes of participating in the distribution of the debtor's estate under the plan of reorganization or liquidation.

they nonetheless submit that, in seeking to safeguard the interests of former stockholders, they are something more than mere volunteers - at least as to those who purchased during the period mentioned.

8. Facts peculiar to ranking of claims of defrauded securities holders as against claims of bank creditors.

As already seen, \$38 million of the \$46.6 million of accepted claims against the debtor consist of claims filed by a consortium of nine banks. A166-8. Accordingly, under the order below, the banks will be distributees of 81.5% of the debtor's estate of approximately \$17 million.¹² A188.

12. On August 12, 1976 the banks received, on account, \$7 million under the March 31, 1976 settlement with the Trustee. A169.

The settlement agreement, A55, ¶3.2, envisages the later allowance of additional general unsecured claims, as well as of priority claims. The agreement, *Id.*, goes on to provide that, notwithstanding the amounts of any such additional claims that might actually be allowed, the sum total of the banks' dividends will be computed as if there were no more than \$50 million (approximately) of general unsecured claims and \$1.9 million of priority claims. If this Court were to reverse Judge Purke's subordination ruling, these provisions would restrict defrauded stockholders to pro rata participation with the non-bank general creditors in 12/50 or 24% of the debtor's \$17 million of distributable assets, except as the banks' claims might be subordinated to those of the stockholders; see Point III, *infra*. As we understand the settlement agreement, in case of such subordination stockholders could qualify for up to \$1.9 million of additional priority distributions out of 38/50 or 76% of the debtor's assets which the agreement otherwise earmarks for the banks.

The foregoing assumes the validity of the settlement agreement. Compare, however, the papers and proceedings leading to court approval of the compromise at A52-145, with Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424-5, 434-5, 440-1 (1968).

A major reason assigned by the proponents of subordination of shareholders' fraud claims to claims of conventional general creditors is that the latter, in extending credit, normally rely on capital previously contributed by stockholders; see Point II, infra. The present bank creditors, however, do not begin to qualify for such protection, assuming the validity of that approach.

The banks extended in excess of \$37 million of unsecured short term credit to the debtor when its capital, contributed by common stockholders, consisted of a mere \$8.5 million. A348, A349, A374. The entire stockholders' equity at that time, including retained earnings, was only \$13 million. A349, A374.

This was the situation when the debtor offered a \$20 million preferred stock issue to the public on July 29, 1971, as shown by the prospectus therefor. A346, A348. The same prospectus promised that this indebtedness would be restructured and enlarged as a one-year revolving credit. A272, A354. Nonetheless, the banks in no way relied, for their continued extension of credit, on a capital contribution from new stockholders: Chemical Bank, an appellee-creditor, unqualifiedly assured the lead underwriter for the preferred stock offering that bank credit would continue to be extended to Stirling Homex, regardless of the outcome of the preferred stock offering. A272; A390, last two ¶¶. Chemical Bank was

the leader of the bank group, A403, ¶6, and acted as agent therefor, A75-6.

Indeed, the defrauded preferred, and many of the common, shareholders may well be entitled to rank ahead of the bank creditors. Appellant-claimant Lonetown Company is currently prosecuting a certified class claim against Chemical Bank for aiding and abetting and conspiring in the issuance of a false prospectus (being the one of July 29, 1971 just mentioned). Allegedly, Chemical Bank, in order to "dress up" the prospectus, complied with a request to furnish a letter advising that it had set up a \$15 million unsecured line of credit for one of the debtor's subsidiaries which had no significant assets and no borrowing capability. Chemical Bank's

letter was artfully hedged so as to negative any meaningful commitment by the Bank. Notwithstanding, on the strength of the Bank's letter the prospectus financials represented without qualification that the debtor's subsidiary possessed an unsecured \$15 million line of bank credit; and the Bank allowed the prospectus to be issued and utilized with that representation. The foregoing is the essence of the third count of Jezarian v. Csapo, the class action previously mentioned as pending in the District Court for the Southern District of New York.¹³ The action has not yet been tried. A motion by Chemical Bank to dismiss the third count as against it, for failure to state a

13. The current complaint in Jezarian v. Csapo will be found at A417. Lonetown Company's third count therein is at A432-5.

claim or to present genuine issues of material fact, was denied by Judge Bonsal in an opinion dated March 3, 1977, reading (in part):

"It appears undisputed that counsel for Chemical was apprised of the footnote in the prospectus as early as July 2, 1971 and suggested at that time that the underwriters check the footnote describing the bank line of credit. However, it does not appear that any further action was taken by Chemical prior to the offering of the preferred stock on July 29, 1971. While such inaction in and of itself may or may not be the basis for a claim of liability under a theory of aiding and abetting in the violation of the federal

securities laws, [citations], it appears that this issue is better left for determination at trial."

In short, the bank creditors cannot fairly assert priority over any defrauded shareholders on the theory of reliance on the stockholders' equity. Moreover, the preferred shareholders, and common stockholders who bought their shares after issuance of the preferred stock prospectus, should have an opportunity to establish that the banks, through the leadership and agency of Chemical Bank, assisted and conspired in the issuance of the false prospectus. If that be proven, the banks' claims should be subordinated to the claims of such shareholders, past and present, under familiar equitable principles; Point III, infra.

POINT I

THE CONTROLLING AUTHORITIES UNIFORMLY
RANK STOCKHOLDERS' FRAUD CLAIMS WITH
CLAIMS OF CONVENTIONAL GENERAL CREDITORS.
JUDGE BURKE ERRED IN HIS BLANKET SUBOR-
DINATION OF ALL THE STOCKHOLDERS' CLAIMS
"IN THE EXERCISE OF DISCRETION."

The claims of Stirling Homex's allegedly defrauded stockholders include, among others, claims against the debtor for violations of the Securities Act of 1933, 15 USC §§ 77a et seq., and of the Securities Exchange Act of 1934, 15 USC §§ 78a et seq. While those claims have yet to be adjudicated, their merit is undeniable. This appears from published findings of the Securities and Exchange Commission and from the conviction, following a jury trial, of the debtor's principal officers of a variety of offenses relating to the defrauding of public investors; pp. 7-11, supra.

The fraud perpetrated on public investors consisted, primarily, of grossly overstating the debtor's income and worth by a method of falsely booking sales of the debtor's principal product. Id. As a result the debtor's securities, although inherently worthless, were readily marketed and at times traded at much higher than their offering prices; pp. 5; 11, fn.3, supra.

Stirling Homex's securities continued to be worthless after the debtor filed its reorganization petition in July of 1972. A88. Losses of public investors, who originally paid

over \$39 million for the debtor's securities, can only be crudely estimated: They have to aggregate in the tens of millions of dollars and could run as high as \$100 million;¹⁴ p.5, supra.

The order below subordinates the fraud claims of all public investors to the claims of conventional general creditors, "in the exercise of discretion." A446. Since the debtor is insolvent, A266, this ruling deprives the investors of all participation in the debtor's estate. There is no precedent or authority for ranking stockholders' fraud claims below claims of conventional general creditors nor is there any basis for the blanket subordination of all such claims as a matter of judicial discretion, as we will now show.

A. The authorities uniformly rank defrauded stockholders with other general creditors.

Nothing in the Bankruptcy Act or in any other statute singles out fraud claims of stockholders for inferior treatment when the issuers become insolvent. To the contrary, as stated in 6A Collier on Bankruptcy, ¶ 9.13, p.238:

14. On the other hand, death, inertia, change of residence and difficulty in locating brokers' confirmations or other evidence of pertinent transactions can be expected significantly to reduce the turnout of potential claimants.

"Creditors holding claims against the debtor's estate of a kind not secured within the meaning of the Act are classified as unsecured or general creditors. The fact that the claims may take various forms - as, for example, notes, accounts, written contracts, torts or the like - will not ordinarily compel separate classification since an unsecured indebtedness or liability is the common denominator of all." [footnotes omitted]

Similarly, in In re Palisades-On-The-Desplaines, 89 F. 2d 214, 217 (7th Cir. 1937):

"All creditors of equal rank with claims against the same property should be placed in the same class. This is natural, logical, and a simple basis of division."

To the same effect: Scherk v. Newton, 152 F. 2d 747, 750-51 (10th Cir. 1945).

Curiously, the notion that stockholders' fraud claims should be subordinated to claims of so-called conventional general creditors seems to stem solely from an article by two law professors, John J. Slain and Homer Kripke, The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U.L.R. 261 (1973). According to these scholars, 48 N.Y.U.L.R. at pp. 284-5, parity treatment for defrauded stockholders is consistent with general American rules as to restitutionary relief which, until the Slain/Kripke article,

were uncriticized in legal literature except for a 1935 student case note.

The Supreme Court readily ruled in favor of parity treatment for defrauded stockholders, in Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206, 214-15 (1937). This was a receivership under the National Bank Act, 12 USC § 191. The plaintiff had obtained a judgment against an insolvent bank in the amount of the price of his stock, by reason of misrepresentations inducing the purchase. It was held that the plaintiff's judgment ranked on a parity with claims of other unsecured creditors.

The Supreme Court has not since addressed the question. When a similar issue arose in Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 453 (1968), a Chapter X case, the Court did not depart from its Oppenheimer ruling, explicitly leaving the question open. See also Tcherepnin v. Knight, 389 U.S. 332, 346 (1967).

Lower court decisions involving this issue have uniformly either explicitly ruled in favor of parity treatment for defrauded stockholders or else have assumed as much.

Thus, in In re Credit Industrial Corp., 366 F. 2d 402 (2d Cir. 1966), a straight bankruptcy, one of the issues was whether the claims of holders of subordinated notes¹⁵ should rank

15. In insolvency proceedings, subordinated debt securities rank with preferred stock. In re Fechheimer Fishel Co., 212 Fed. 357, 360 (2d Cir.), cert. den. 234 U.S. 760 (1914).

below claims of bank creditors. The note holders sought parity treatment, alleging that they had been induced to purchase their securities by fraud of the bankrupt. The Court, at pp. 411-12, held that note holders' fraud claims should stand, "without prejudice to an appropriate resolution thereof upon the law and facts as developed."

Matter of Cartridge Television, Inc., 535 F. 2d 1388 (2d Cir. 1976), dealt with the allowability of stockholders' fraud claims against the issuer-debtor in a straight bankruptcy. The Court, at page 1391, alluded to the Slain and Kripke article but nonetheless assumed that the claims, if allowed, would be entitled to parity treatment.¹⁶ The claims were disallowed only because of their uncertain merit and provability.¹⁷

16. Conventional general creditors' claims against the debtor in that case amounted to \$3 million, as against net assets of \$800,000. 535 F. 2d at p. 1389. If the Court had considered that the stockholders' fraud claims were subordinate to conventional creditors' claims, the points discussed in Judge Mansfield's extended opinion would all have been thoroughly academic.

17. Bankruptcy Act § 57(d), 11 USC § 93(d), permits of discretionary rejection of unliquidated or contingent claims whose determination might unduly delay administration of the estate. Section 57(d) is inapplicable in Chapter X proceedings. 6A Collier on Bankruptcy, pp. 136, 170. Furthermore, the fraud claims of the stockholders at bar, although unliquidated, are of clear merit and easy provability; pp. 7-11, supra; pp. 32-3, infra.

In In re Four Seasons Nursing Centers of America, Inc., 472 F. 2d 747 (10th Cir. 1973), the court found to be fair a Chapter X reorganization plan which gave one-third of the assets to defrauded shareholder claimants, to the exclusion of shareholders' equity interests. This was on the ground, at p. 750, that the defrauded security holders [referred to as "Class G claimants"] "were in fact and in law creditors".

A similar finding was made in another Chapter X reorganization, Matter of Equity Funding Corp. of America, 416 F. Supp. 132 (C.D. Calif. 1975). Judge Pregerson observed in that case, at p. 151, that "There is authority for the proposition that a fraud claim, even if based upon stock acquisition, is on a parity with general unsecured claims in a reorganization proceeding."

In re Los Angeles Land and Investments, Ltd., 282 F. Supp. 448, 453-4 (D. Hawaii 1968), aff'd 447 F. 2d 1366 (9th Cir. 1971), is another application of the Oppenheimer rule. This was a Chapter X reorganization in which defrauded holders of contracts with the debtor, held to be securities as defined in the Securities Act of 1933, 15 USC § 77a et seq., were included in a single class of general unsecured creditors. Also in point is Securities and Exchange Commission v. Insurance Investors Trust Co., '71-'72 CCH Fed. Sec. L. Rep. ¶ 93,259 (W.D. Ky. 1971), a receivership where defrauded stockholder claimants were ranked on a parity with conventional creditors.

All these authorities favored recognition of defrauded security holders as general creditors. We have found no contrary rulings. In the court below our adversaries relied on Matter of Weis Securities, Inc., 425 F. Supp. 212 (S.D.N.Y. 1977), now under advisement by this Court. Weis, in our view, is completely distinguishable from the case at bar because the insolvent debtor in Weis was a securities broker-dealer, strictly regulated by federal law. In that case the allegedly defrauded security holders were subordinated lenders of the debtor. As noted in Judge Wyatt's opinion, at p. 217, the debt securities there involved were subordinated not only by contract but by federal regulation, i.e., the net capital rule as then in effect; Securities Exchange Act § 8(b), 15 USC § 78h(b). Thus Weis in no way supports subordination in the case at bar.

B. Judge Burke lacked discretion to subordinate the stockholders' fraud claims.

So far as can be discerned from his opinion, A440, Judge Burke rested his discretionary subordination of stockholders' fraud claims on two grounds: (1) The supposed uncertainty of the claims, and (2) The Judge's view that the public interest would better be served by subordinating all such claims to the claims of general creditors. We submit that Judge Burke was manifestly in error on both counts.

With regard to the quality of the claims, Judge Burke, at A444, quoted at page 7, supra, wrote that the stockholders' claims are contingent and unliquidated and that the claimants may never be creditors, that determination of such claims involves serious factual and legal issues, and that substantial disputes can be expected to arise in applying statutes of limitations to such claims and in fixing damages. The record facts are all to the contrary, as regards the merits and provability of the claims and the fixation of resulting damage; pp. 7-11, supra. Also, Bankruptcy Act § 11(f), 11 USC §29(f), obviates any limitations problems here by tolling applicable statutes of limitations on the filing of the petition; pp. 10-11, supra.

Moreover, under § 106 of the Bankruptcy Act, 11 USC § 506, Chapter X is to deal with "all claims of whatever character against the debtor or its property, except stock, whether or not such claims are provable under section 63 of this Act and whether secured or unsecured, liquidated or unliquidated, fixed or contingent; ..." Chapter X is unique among the bankruptcy statutes. It sacrifices speed and economy in favor of thoroughness and impartiality, to the end of protecting all creditor and stockholder interests involved. Securities and Exchange Commission v. American Trailer Rentals Co., 379 U.S. 594, 605-7 (1965). Hence, in Chapter X, claims are not to be passed over by reason only of their uncertainty.

But even assuming, arguendo, that the District Court were empowered, in a Chapter X proceeding, to disallow claims on such a ground, it would be a clear abuse of discretion to subordinate - i.e., to disallow - claims like those at bar, of plain merit and easy provability. Matter of Cartridge Television, Inc., supra, 535 F. 2d at pp. 1390-1, held that the claims there involved had been properly rejected because they were vigorously contested, involved complex issues of fact and law and probably would not be disposed of for several years. The opinion was careful to point out, however, that the ruling might well have been otherwise if the claims had been easily provable (p.1391):

"Of course the bankruptcy judge cannot exercise unbridled authority in the disallowance of a stockholder's claim of fraud. In re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747 (10th Cir. 1973) (Chapter X proceeding); In re William Rakestraw Co., 450 F.2d 6, 9 (9th Cir. 1971). To reject an easily provable securities fraud claim, for instance, might well amount to an abuse of discretion. On the other hand, the court should not be powerless to act. The Act plainly contemplates that the bankruptcy judge must exercise reasonable discretion in utilizing § 57(d) and on the facts of this case we are satisfied that appellant cannot even remotely demonstrate an abuse of discretion on Judge

Herzog's part in finding appellants' securities fraud claims to be too contingent and remote to be allowable."
[underscoring added]

A fortiori, it was plain error to subordinate the stockholders' fraud claims in the case at bar because (1) § 57(d) does not apply in this Chapter X proceeding,¹⁸ and (2) the claims are easily provable.

Judge Burke's other ground for discretionary subordination of stockholders' fraud claims is his belief that our financial structure will be undermined if such claims are given parity treatment:

"If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit in the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the busi-

18. See footnote 17, supra.

ness community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority."

A444.

It is not for the courts but for the Congress to determine, we submit, whether unambiguous provisions of the Bankruptcy Act are to be modified and, if so, how the competing interests of defrauded shareholders and other creditors are to be resolved. Professors Slaine and Kripke, from whom the foregoing thesis is borrowed, themselves acknowledge that existing law is to the contrary: Their whole article is a plea for legislative modification.¹⁹

19. A Senate subcommittee has commenced hearings on a proposed new bankruptcy law, S. 2266. Section 510 thereof would mandate subordination of rescission and damage claims arising from the purchase and sale of the debtor's securities. A similar provision was contained in a House bill to reform the Bankruptcy Act, H.R. 8200, § 510 thereof, which failed of passage, after a floor vote, on October 28, 1977; Wall St. Journal, October 31, 1977, p. 5.

The Report on H.R. 8200 of the House Committee on the Judiciary, H.R. Rep. No. 95-595, 95th Cong., 1st Sess., pp. 194-5 (1977), cites Oppenheimer v. Harriman National Bank and Trust Co., supra, 301 U.S. 206, 214-15 (1937), as the controlling authority on the general question. The same Committee Report, at pp. 195-6, notes that the Securities and Exchange Commission opposes mandatory subordination. The Commission's position is stated at length in Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary, 94th Cong. 1st and 2d Sess. ser. 27, pt. 4 at pp. 2184-6 (1975-6).

The absolute priority rule, referred to at the conclusion of the passage just quoted from Judge Burke's opinion, was established well in advance of Oppenheimer v. Harriman National Bank and Trust Co., supra, 301 U.S. 206, 214-15 (1937).²⁰ Obviously, the Supreme Court did not view parity treatment for defrauded shareholders as conflicting with the absolute priority principle.

Again, to apply the absolute priority rule in denigration of the fraud claims, as distinguished from the equity interests, of stockholders is for the Congress, not the courts. Moreover, the absolute priority rule has so far been applied to limit the equity interests or participations only of present shareholders. The order below would extinguish the claims of former shareholders as well - a reach of the absolute priority rule beyond any precedent that has come to our attention.

The doctrine of equitable subordination in bankruptcy and reorganization law, which Judge Burke presumably was invoking, is a device for denying equal treatment to creditors because of particular inequitable, fraudulent or unconscionable conduct in which they have engaged. In re Credit Industrial Corp., 366 F. 2d 402, 408-9 (2d Cir.1966); In re Four Seasons

20. For the history and development of the absolute priority rule, see Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 436, fn. 2, Douglas, J. dissenting (1972).

Nursing Centers of America, Inc., 483 F. 2d 599, 602-3 (10th Cir. 1973); 3 Collier on Bankruptcy, ¶ 57.14, pp. 229-33; 6A Id., ¶ 9.15. As indicated by these authorities, equitable subordination should be based upon operative facts in the individual case, not merely upon the judge's economic or social concepts and philosophy.

If the defrauded stockholders of Stirling Homex are to be ranked below all its other creditors on account of the generalized considerations cited by Judge Burke, then the same should hold true for all defrauded shareholders of whatever issuers. Such a proposition, even if soundly conceived, is not an "equity". Rather, it is arrant judicial legislation: Another judge, more imbued than Judge Burke with the need to protect public investors, could just as easily, in the exercise of his "discretion", subordinate conventional general creditors to defrauded stockholders.

The Reorganization Judge in our case, we submit, completely misconceived his role and his authority in the classification of claimants.

POINT II

THE BANK CREDITORS IN THIS CASE DID NOT RELY ON THE CAPITAL CONTRIBUTIONS OF THE DEFRAUDED STOCKHOLDERS. HENCE THE STOCKHOLDERS' FRAUD CLAIMS SHOULD RANK WITH THE BANKS' CLAIMS EVEN ASSUMING, ARGUENDO, THAT DEFRAUDED STOCKHOLDERS, AS A GENERAL PROPOSITION, SHOULD BE SUBORDINATED TO CONVENTIONAL GENERAL CREDITORS.

This Point assumes that the Court is not persuaded that stockholders' fraud claims must be accorded parity treatment, as urged in Point I hereof. In such case the Court, no doubt, will have given weight to the postulates of Professors Slain and Kripke in their previously discussed article, The Interface Between Securities Regulation and Bankruptcy - Allocating the Risk of Illegal Securities Issuance Between Securityholders and the Issuer's Creditors, 48 N.Y.U.L.R. 261 (1973). But Slain/Kripke would not favor subordination of the stockholders' fraud claims to the claims of the bank creditors, as a matter of principle or of policy, on the facts of this case.

The centerpiece of the Slain/Kripke argument against parity treatment of stockholders' fraud claims is the creditors' presumed reliance on a cushion of capital contributed by the stockholders. 48 N.Y.U.L.R. at 286 et seq. The present bank creditors cannot demonstrate any such reliance.

The record here shows that the banks lent the debtor, without security, no less than \$37 million when the debtor's equity capital was a mere \$8.5 million, contributed by common stockholders; p. 21, supra. Furthermore, the banks pledged themselves to continue and enlarge this credit while the debtor's preferred stock offering was in registration, irrespective of the outcome thereof; p. 21, supra.

Slain/Kripke plainly would refuse preferential treatment of the banks' claims on this state of facts, except possibly to the extent of \$8.5 million as against the fraud claims of the common shareholders (48 N.Y.U.L.R. at 289);

"If reliance is to be the touchstone between creditor and rescinding stockholder, a distinction should be drawn between credit obligations incurred before and after the stockholder's investment. An occasional case may arise in which a prior creditor can demonstrate that he later changed his position in reliance on the stockholder's investment. For example, a creditor may release a security interest, renew a term loan or waive an event of default upon learning of an apparent improvement in the debtor's equity position. In general, however, it is unlikely that a prior creditor will be able to show even derivative reliance. Consequently, while subsequent creditors should be presumed to have relied on the rescinding stockholder's investment, prior creditors should

be required to sustain the burden of proving their detrimental reliance."²⁰

A kind of corollary of the cushion-reliance theory, also presented by Slain/Kripke, 48 N.Y.U.L.R. at 286-7, is the notion that stockholders' fraud claims should rank below claims of conventional creditors because stockholders assume greater risks than conventional creditors, in the hope of gaining greater profit. This concept was adopted by Judge Burke in his opinion below:

"Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks. Conventional creditors are presumed to have dealt with the corporation with the reasonable expectation that they would have a senior position against its assets, to that of alleged stockholder claims based on fraud. They may be presumed to have bargained for debt type profits and certainty of payments." A445.

That rationale likewise in no way fits the role of Stirling Homex's bank creditors. In lending to the debtor they took truly extraordinary, un-banker-like risks, no doubt

20. Slain and Kripke, as we read their article, do not envisage bifurcation of claims, depending upon the timing of the underlying credit transactions, as we suggest in introducing the foregoing quotation. Bifurcation, under these circumstances, would seem to be a logical extension of the Slain/Kripke thesis - which, however, we urge the Court to reject for the reasons advanced in Point I hereof.

in the hope of cementing relations with what appeared to be the leading company in an exciting new industry with infinite growth possibilities - perhaps another Xerox or Polaroid. With regard to the debtor's bankers, our case is not an instance of the creditors leaning on the stockholders but of the stockholders relying on the creditors. According to Richard S. Simmons of Cravath, Swaine & Moore, a Chemical Bank lawyer, A272, the following took place at a July 2, 1971 meeting, A389, between representatives of Chemical Bank and of Merrill Lynch, Pierce, Fenner & Smith, lead underwriter for the debtor's preferred stock, then in registration:

"Following our discussion, Mr. Hazen [of Chemical Bank, A389] and I went upstairs to the luncheon, at which representatives of Merrill Lynch, and Brown, Wood, Fuller, Caldwell and Ivey, the law firm representing Merrill Lynch, were present.

The representative of Merrill Lynch reviewed a fairly lengthy deficiency letter from the SEC. He also stated that it was essential in order to enable Merrill Lynch to go forward with the undertaking that it be assured that Chemical would continue to support Stirling Homex through extensions of credit.

Mr. Hazen responded that Chemical had every intention of continuing to extend credit to Homex but that Chemical wanted such extensions of credit to be made pursuant to a formalized revolving credit agreement with adequate controls, particularly to curtail the speculative

building of modules. He stated that Chemical had been concerned about Homex's cash flow problems caused by the time lag between the production of modules and the on-site installation and payment therefor. I also believe that Richard LeBlond, an Executive Vice President of Chemical, made a general statement about the fact that Chemical viewed Homex as making a very substantial contribution in the public housing field and was confident as to its future." A390.

At this time Chemical Bank was the leader of the bank group and was acting as agent therefor; pp. 21-2, supra.

Graham and Dodd, in their classic Security Analysis (4th Ed. 1962), Ch. Forty, teach that debt of 33% to 35% of the borrower's total capital is the limit of conservative lending. In our case the banks lent \$37 million against a total capital (including the banks' unsecured loans) of \$50 million, A349, a ratio of debt to capital of 74%! Altogether, we see little to choose, in nature or degree, between the risk assumed by the bankers and the risk taken by the stockholders; and there is no discernible reason that losses resulting from the Company's insolvency should be borne by its defrauded shareholders in preference to its high-risk professional lenders. Indeed, if the banks and the defrauded stockholders are not to be accorded equal treatment, the case for subordinating the banks to the stockholders impresses us as having a good deal more substance,

on the operative facts, than the generalized argument for giving the banks priority as "conventional" general creditors.

POINT III

THE BANKS' CLAIMS SHOULD BE EQUITABLY SUBORDINATED TO THE FRAUD CLAIMS OF THE PREFERRED STOCKHOLDERS AND OF MANY OF THE COMMON STOCKHOLDERS, UPON THEIR ESTABLISHING THAT THE BANKS AIDED AND ABETTED THE ISSUANCE OF A FALSE PROSPECTUS FOR THE PREFERRED STOCK.

The debtor's preferred stock was offered under a prospectus of July 29, 1971 which represented that U. S. Shelter Corporation, its wholly owned financing subsidiary, had obtained an unsecured \$15 million line of credit from a bank. A 379. Shelter was an empty shell with no borrowing capability, A48, so that, plainly, the representation that it enjoyed a large unsecured line of bank credit was highly material.

The representation also was completely false. It was made on the strength of a letter addressed to Shelter by appellee Chemical Bank, to satisfy a request for such a document by the lead underwriter of the preferred stock offering, so that the prospectus could indicate that Shelter had proper financing. No unsecured line of credit for Shelter was ever intended or established by the Bank. Appellant Lonetown Company has so alleged, in charging the Bank with aiding and abetting and conspiring in the issuance of a

materially false registration statement and prospectus, and, accordingly, with committing a fraud on the later-purchasing stockholders. This claim is made in the third count of Jezarian v. Csapo, the previously mentioned certified class suit pending in the District Court for the Southern District of New York. A432; pp. 22-3, supra. The claim has survived a summary judgment motion by the Bank, Id.; and it is awaiting trial.

Chemical Bank was the leader of the bank group, including all the appellee banks, and acted as agent therefor; pp. 21-2, supra. Manifestly, it was in the interest of all the banks in the consortium that the preferred stock offering succeed. While Chemical Bank is the only one of the group so far charged in Jezarian v. Csapo with the alleged fraud, all the banks are answerable as principals for a fraud perpetrated by Chemical Bank within the scope of its agency. Ricketts v. Pennsylvania R. Co., 153 F. 2d 757, 759 (2d Cir. 1946); Myzel v. Fields, 386 F. 2d 718, 738 (8th Cir. 1967), cert. den. 390 U.S. 951 (1968); In re Sabre Shipping Corp., 299 F. Supp. 97, 100 (S.D.N.Y. 1969); Keck v. Wacker, 413 F. Supp. 1377, 1383 (E. D. Ky. 1976); Restatement 2d, Agency, § 216 (1958).

It is settled law that creditors who have perpetrated a fraud on other creditors should have their claims subordinated to the claims of their victims. Taylor v. Standard Gas and Electric Co., 306 U.S. 307 (1939); Heiser v. Woodruff, 327 U.S. 726, 732-3 (1946); Pepper v. Litton, 308 U.S. 295 (1939); Wheeling Valley Coal Corp. v. Mead, 171 F. 2d 916, 920-21 (4th Cir. 1949); 1 & Sons Sales Corp. v. Tobin, 78 F. 2d 371, 374 (8th Cir. 1935); In re Desnoyers Shoe Co., 210 F. 533, 538-39 (S.D. Ill. 1914), aff'd 224 F. 372 (7th Cir. 1915); In re Bowman Hardware & Electric Co., 67 F. 2d 792, 794, 795 (7th Cir. 1933); 3 Collier on Bankruptcy, ¶ 57.14, pp. 229-33; 3A Collier on Bankruptcy, ¶ 63.08, p. 1825; ¶ 65.06, p. 2293.

The preferred shareholders, past and present, should have the opportunity to establish that the banks were implicated in the prospectus fraud. The same applies to past and present common stockholders who bought their shares after issuance of the false prospectus; cf. Fischman v. Raytheon Mfg. Co., 188 F. 2d 783, 786-8 (2d Cir. 1951). If the stockholders succeed, the banks' claims should be subordinated to those of the defrauded stockholders, irrespective of the resolution of the issues discussed in the preceding Points hereof.

POINT IV

NOTICE REQUIRING THE FILING OF STOCK- HOLDERS' FRAUD CLAIMS HAS YET TO BE GIVEN.

We expect some of our adversaries to urge here, as they did below, that stockholders' fraud claims are covered, and are accordingly now precluded, by the December 11, 1972 bar order, A24. Appellants dispute that. Judge Burke did not reach this question, and his opinion does not mention it.

We proceed to show that (A) the text of the bar order explicitly excepted stockholders' fraud claims; and (B) The order was insufficiently served on the debtor's former stockholders in that they were omitted from the mailing of the order although their names and addresses were readily available from the Company's stock transfer records.

A. The bar order excepted stock-
holders' fraud claims.

If the December 11, 1972 bar order was meant to encompass claims of defrauded security holders, it is startling to discover that only six such claims, totalling some \$22,000, were filed before the February 19, 1973 bar date. A173. Over 1,175,000 shares of the debtor's common stock and 500,000 shares of its preferred stock were sold to the public for some \$39 million. A157. All those shares are worthless; p. 11, supra. Potential claimants obviously number in the thousands; and their total claims, in the multi-millions of dollars.

The paucity of stockholders' fraud claims in the Chapter X proceeding contrasts with the extensive plenary litigation brought by allegedly defrauded Stirling Homex stockholders. See In re Stirling Homex Corporation Securities Litigation, 388 F. Supp. 567, 568; Id. 570 (JPML 1975).

The explanation for the conspicuous absence of filed claims of defrauded stockholders is, simply, that the December 11, 1972 bar order did not call for such claims. Whether the order is looked at in light of the ordinary meaning of the words used or in light of the traditional and more technical meaning given those words in bankruptcy terminology and practice, it is plain that stockholders' fraud claims were excluded.

We quote below all possibly relevant paragraphs of the bar order (A24):

"1. All proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated, other than those founded on bonds, bond interest coupons, or shares of stock, shall be filed with the Trustee of the debtors, at 10 Lafayette Square, Buffalo, New York 14203, on or before February 19, 1973; ****.

2. All proofs of claim of the *interests of stockholders* of said debtors shall be filed with said trustee, at his said office, at any time on

or before the time to be fixed herein within which the creditors and stockholders of said debtors affected thereby may accept the plan or plans approved by this court pursuant to Section 174 of the Bankruptcy Act.

* * * * *

7. *Stockholder's interests* shall be proved by an affidavit executed by the claimant setting forth:

- (a) the name and address of the holder;
- (b) the kind of stock;
- (c) the number of shares held by claimant;
- (d) the respective dates of the acquisition of such shares.

8. Any proof of claim of creditors and of *interests of stockholders* heretofore filed in this proceeding substantially in such form shall be deemed to have been filed in accord with the provisions of this order.

9. Paragraph 1 of this order shall operate against all creditors, security holders and *stockholders* inclusive of the United States of America and of any state or political subdivision thereof.

10. On or before January 5, 1973 a copy of this order shall be mailed by the Trustee to all creditors and *stockholders* at the addresses shown on the records of the debtors or as otherwise known to the Trustee, and to the Securities and Exchange Commission. *** In addition, the Trustee shall publish or cause to be published a copy of this order, once during the month of January, 1973 in the Wall Street Journal and in the Rochester Democrat and Chronicle.

11. For the purposes of determining acceptances of any plan of reorganization and the sufficiency in number and amount thereof, a proof of claim properly executed and filed in accordance with the provisions of this order shall be deemed allowed, unless objections to the allowance thereof are filed at least three days prior to the date set for the hearing of an application to confirm such plan, except that no claim shall be counted, which has actually been disallowed prior to such hearing. Such objections may be filed by the respective debtor, by the Trustee or by any creditor, or by any *stockholder*, if the debtor is not insolvent." [italics ours]

For the ordinary or lay reader there was no need to go beyond ¶ 1 to determine that the February 19, 1973 bar date had no application to stockholders' claims: Plainly such claims are "founded on shares of stock" and hence were expressly excepted from ¶ 1's filing requirements. Our adversaries have argued that stockholders' fraud claims are tort claims, encompassed not by the "other than" or exception clause, but by the words "All proofs of claim...". This argument overlooks that the pronoun "those" in the "other than" or exception clause has, as its antecedent, the principal "All proofs of claim" clause. On replacing "those" in the exception clause with the italicized antecedent of "those", the exception clause reads as follows:

"other than proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated,

founded on ... shares of stock."

There is nothing in the succeeding paragraphs of the bar order which is in any way inconsistent with ¶ 1's exception of stockholders' claims. Paragraphs 2, 7 and 8 refer only to the "interests", not the "claims" of stockholders. Paragraphs 9, 10 and 11 likewise make no reference to stockholders' "claims". In view of ¶ 1's exception of stockholders' claims, ¶¶ 9-11 can only be read as relating to stockholders as equity owners rather than as claimants.

So much for the ordinary meaning of the bar order. Reading it with an eye to bankruptcy usage leads to the same conclusion: As applied to stockholders, "claim" and "interest" have well understood and sharply differentiated meanings. J.P. Morgan & Co. v. Missouri Pac. R. Co., 85 F. 2d 351, 352 (8th Cir.), cert. den. 299 U.S. 604 (1936); 6A Collier on Bankruptcy ¶ 9.02, p.131. A creditor is said to have a claim against a debtor, while a stockholder ordinarily has only an interest in the debtor. But a stockholder who alleges that he was fraudulently induced to buy his stock has a claim against the debtor as well as his interest in the debtor. Such a claim is one founded on shares of stock.

Ordinarily, in Chapter X proceedings proofs of claim, as well as of interests, founded on securities need not be filed until the time for voting on the reorganization plan. See, e.g., Rule X-20 of the Bankruptcy Rules for the New York Southern and Eastern District Courts, Rule X-18 for the Missouri Eastern District Court, Rule X-14 for the Pennsylvania Eastern District Court;²¹ 7 Collier on Bankruptcy, Form 2202, at p. 308, ¶ 2. In our case, whether by oversight or design, the bar order is completely silent on when "proofs of claim ... founded upon securities" are to be filed.²² Consequently those creditors whose claims are founded on stock were not in any way addressed by the bar order.

It is settled law that persons whose rights are to be affected by a court proceeding are entitled to notice reasonably calculated to convey the required information. Anything less is a deprivation of due process. Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 315 (1950). This principle is vital in bankruptcy proceedings. City of New York v. New York, N.H. & H.R. Co., 344 U.S. 293 (1953).

21. The Western District of New York has no counterpart of the cited Rules.

22. The quoted words appear in the three Rules and in Collier's form of bar order, cited in the text, supra.

With regard to the standard for reasonable and adequate notice, the decisions are well summarized in 66 CJS, Notice, § 16, pp. 653-4:

"Generally speaking, when a formal notice is required, it should give the necessary information, and must apprise the person whose rights are to be affected of what is required of him ...

A notice must be clear, definite, and explicit, and not ambiguous. The notice is not clear unless its meaning can be apprehended without explanation or argument."
[footnotes omitted]

The bar order in this case woefully fails that test, if it was meant to cover stockholders' fraud claims.

B. The bar order was insufficiently served on stockholders.

Even if the text of the bar order had intelligibly embraced stockholders' fraud claims, the mode of service of the order rendered it inapplicable to a great many stockholder-claimants.

The bar order directed that it "be mailed by the Trustee to all creditors and stockholders at the addresses shown on the records of the debtors or as otherwise known to the Trustee." A25, ¶10. In the case of stockholder-creditors, however, mailing was effected only to stockholders of record on December 29, 1972. A42. Stockholder-creditors, of course, in no way were so restricted a group; they included

all purchasers of Stirling Homex stock since the Company went public in February of 1970. A large number of those stockholder-creditors were no longer stockholders of record in December 1972.

The Trustee should have known, when he applied for the bar order, of the existence of stockholders' fraud claims, from his own investigation and from pending litigation, including a class suit against the debtor for the benefit of shareholders, past and present; p. 15, supra. The Trustee also had the names and addresses of all stockholders who had ever been registered as such, from the Company's transfer records. A248-50.

It is routine, in security holders' class actions, to use stock transfer records to compile mailing lists to give notice to class members. There was no good reason not to utilize the debtor's stock transfer records to give notice to former stockholder-creditors in this case. The Trustee suggested, much later, that including former stockholder-creditors in his mailing would have been onerous and too costly. A249-50. As has been seen, however, there is much reason to doubt that the Trustee meant to cover stockholders' fraud claims by the bar order; see also A248-9, quoted at p. 57, infra. Be that as it may, the crucial point here is that former stockholder-creditors have yet to be given the personal notice to which they are entitled before they are barred for failure to file their claims.

When notice is required and the names and addresses of those to be notified are known or reasonably ascertainable, due process requires individual notice; and published notice will not suffice. Mullane v. Central Hanover Bank and Trust Co., 339 U.S. 306, 318 (1950); Schroeder v. City of New York, 371 U.S. 208, 212-13 (1962); Eisen v. Carlisle & Jacquelin, 417 U.S. 156, 173-5 (1974).

In bankruptcy the controlling authority on the insufficiency of published notice is City of New York v. New York, N.H. & H.R. Co., 344 U.S. 293 (1953). There, New York City had lien claims against the New Haven Railroad. The railroad was reorganized under § 77 of the Act; and its properties were transferred to a new company, supposedly free of the City's liens. The City had failed to file a claim in the reorganization proceedings but contended that the bar order did not apply to it because it had not been given notice by mail, but only by publication, of the time to file claims. The Court sustained the City's liens against the reorganized company on the authority of Mullane, supra, writing, per Mr. Justice Black, (p. 296):

"Notice by publication is a poor and sometimes a hopeless substitute for actual service of notice. Its justification is difficult at best. See Mullane v. Central Hanover Bank & Trust Co. 339 US 306, 94 L ed 865, 70 S Ct 652. But when the names, interests and addresses of persons are unknown, plain

necessity may cause a resort to publication. See, e.g., *Standard Oil Co. v. New Jersey*, 341 U.S. 428, 95 L ed 1078, 71 S Ct. 822. The case here is different. No such excuse existed to justify subjecting New York's claims to the hazard of forfeiture arising from 'constructive notice' by newspaper."

The New Haven case has recently been applied in Chapter X proceedings to save claims of known creditors who were denied notice by mail to file claims. In re Harbor Tank Storage Co., 385 F. 2d 111, 115 (3rd Cir. 1967); In re Intaco Puerto Rico, Inc., 494 F. 2d 94, 99 (1st Cir. 1974).²³

Concededly, all the appellants were shareholders of record on December 29, 1972, so that none of them is aggrieved by the failure to mail the bar order (assuming that it encompassed the claims in question) to the former stockholder-creditors whose names and addresses were known. As already noted, however, pp. 18-20, supra, the ultimate issue is the framing of a fair plan of reorganization; and no plan can be deemed fair that eliminates a group of creditors as time-barred when they never had adequate, if any, notice of the bar order. This point, we submit, should be considered as going to the

23. The principle enunciated by the foregoing authorities is now embodied in Rule 10-209(c)(2), (f) of the Chapter X rules, which became effective on October 1, 1973.

fairness of the terms of reorganization, even though appellants were not personally affected thereby. Comstock v. Group of International Investors, supra, 335 U.S. 211, 226-7 (1948). In urging the point, the three appellants who are plaintiffs in Jezarian v. Csapo, a pending class action for defrauded buyers of Stirling Homex stock between March 16, 1971 and July 10, 1972, A190, are not altogether volunteers, at least with regard to former stockholders who bought during that period.

POINT V

AS A MATTER OF DUE PROCESS, THE CALL
FOR STOCKHOLDERS' FRAUD CLAIMS SHOULD
FOLLOW THE TRUSTEE'S § 167 REPORT,
WHICH WAS NOT COMPLETED UNTIL MORE THAN
FOUR YEARS AFTER THE 1972 BAR ORDER.

One of the most important duties of a reorganization trustee is to "investigate the acts, conduct, property, liabilities, and financial condition of the debtor ... and report thereon to the judge." Bankruptcy Act § 167(1), 11 U.S.C. § 567(1). The fraud claims of the present debtor's stockholders arise from the debtor's false accounting, set forth in the Trustee's § 167 report, A158, last ¶, quoted at p. 8, supra.

The bar order was made on December 11, 1972. A26. The Trustee's § 167 report was not completed and filed until April 18, 1977. A175, A154. At the court hearing preceding the order under review, the Trustee took the position that he did not know and could not have known of the existence of the stockholders' fraud claims at the time of the bar order:

"MR. RAICHLE: Just a word about this matter of notice. If Your Honor will go back in thought and memory to the time of my appointment, there was no evidence before the Court that there existed a class of defrauded stockholders. I entered upon the performance of my duties with the usual information, sources of information. I knew that I could find from the company's books and records, at least in the first instance, the names and addresses of the creditors. I knew that I could find from the books and records of the company and the transfer agent the names and addresses of the stockholders of record, the two classes of parties in interest contemplated by the provisions of the Bankruptcy Act providing for notice. I had no information in the early days or for considerable months after my appointment, and you might say years after my appointment, there existed the bases for a claim of fraud on the part of stockholders. I held extensive hearings in late '72, early '73, and I think, to some extent, a year or two later the Securities & Exchange Commission asked me to step aside in the matter of my investigation so that its representatives could conduct their investigation, making the argument which had sense to me at the time and makes sense now, that they could do it in secret, whereas I was doing it in open court, and it was being spread on the pages of the paper.

It was not until the SEC filed its report some two or three years later that the detail of the alleged fraud became known. I had intimations. I had reason to believe shortly before the filing of the SEC report that there might be some instances of fraud, but what was I to do, I ask rhetorically, in the matter of notice. ***" A248-9.

At the time of the bar order the Trustee had taken extensive testimony from members of prior management. A269-70. The Jezarian class suit for defrauded stockholders was also pending against the debtor. A271, A334. If the Trustee, nonetheless, was insufficiently informed at the time of the bar order of the existence of stockholders' fraud claims against the debtor, how can rank and file shareholders be expected to have filed their claims at that early date?

The Trustee, to his credit, has not joined other of our adversaries in invoking the bar order, A250, although he did join them in urging subordination for defrauded stockholders, A250-1.

Assuming, arguendo, that the December 11, 1972 bar order was intended and drawn as a call for stockholders' fraud claims, it would be manifestly unfair to give it such effect when the § 167 report was not filed until some four and a half years later. Concededly there is no problem with an early call for claims of trade and other conventional creditors. But what is the purpose of a § 167 report on the acts, conduct and liabilities of the debtor if the claimants, for whose benefit it is intended, are cut off before the report is rendered?

We submit that in reorganizations involving false accounting and other misconduct by the debtor's management, common sense as well as due process mandate deferral of the required filing of claims by affected parties until the Trustee

has completed his § 167 investigation and his report becomes available. See In re Philadelphia & Reading Coal & Iron Co., 105 F. 2d 354, 356 (3rd Cir. 1939); In re Central Forging Co., 31 F. Supp. 1020, 1022-3 (D.C.M.D. Pa. 1940). In the Westec Corp. reorganization, S.D. Tex No. 66-H-62, the bankruptcy judge found that the existence of stockholders' fraud claims against the debtor was not generally known until the filing of the § 167 report, some time after the expiration of the general bar date; on this account the judge extended the bar date for such claims until after the filing of the report.²⁴ The same should be done here, if it be determined that the 1972 bar order literally encompassed stockholders' fraud claims and that the order was properly served on former stockholders.

CONCLUSION

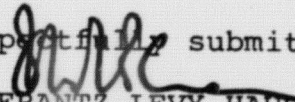
The Order appealed from should be reversed with directions (A) To classify fraud claims of past and present stockholders on a parity with general claims of all other creditors, subject, however, to equitable subordination of the claims of the bank creditors to the fraud claims of the preferred stockholders, past and present, upon their estab-

24. See Westec Order Approving Plan of Reorganization, dated February 28, 1969, ¶ 1.

lishing that the banks were implicated in the issuance of a false prospectus for the preferred stock, and subject as well to equitable subordination of the claims of the bank creditors to the fraud claims of the common stockholders, past and present, who bought their shares after issuance of the false prospectus; and (B) To instruct the Trustee to solicit fraud claims from individual stockholders, past and present, for filing hereafter by a prescribed date.

Dated: New York, New York
November 28, 1977

Respectfully submitted,


POMERANTZ LEVY HAUDEK & BLOCK
Attorneys for Appellants Gregory
Jezarian, Geraldine Jezarian and
Lonetown Company
295 Madison Avenue
New York, New York 10017
(212) 532-4800

MILBERG WEISS BERSHAD & SPECTHRIE
Attorneys for Appellants Harry E.
Jones and Aleck Goldberg, as
Custodian for Mark Goldberg
One Pennsylvania Plaza
New York, New York 10001
(212) 594-5300

BADER AND BADER
Attorneys for Appellant Mrs. D.
Windsor Dixon
270 Madison Avenue
New York, New York 10016
(212) 532-6860

Robert B. Block
Roger W. Haudek
Of Counsel

CERTIFICATE OF SERVICE

I am over the age of 18 years and am in the employ of Pomerantz Levy Haudek & Block.

On November 30, 1977 I served the annexed Appellants' Brief on all of the following attorneys for appellees by delivering two copies thereof, each enclosed in a sealed post-paid first-class envelope, to the United States Postal Service in the post office maintained at Lexington Avenue and 45th Street, New York, New York, addressed as follows:

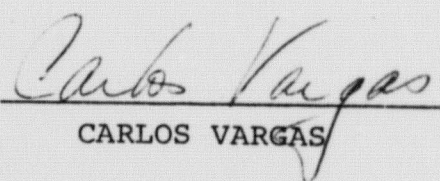
Johson, Reif and Mullan
47 Fitzhugh Street
Rochester, New York 14614

Nixon, Hargrave, Devans & Doyle
Lincoln First Tower
Rochester, New York 14603

Zalkin, Rodin & Goodman
750 Third Avenue
New Ycrk, New York 10017

Phillips, Lytle, Hitchcock,
Blaine & Huber
3400 Marine Midland Center
Buffalo, New York 14203

Brown, Kelly, Turner, Hassett
& Leach
290 Main Street
Buffalo, New York 14202


CARLOS VARGAS